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SIA SECURITIES INDUSTRY ASSOCIATION

TRENDS

An Analysis of Emerging Trends in the Securities Industry

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"FROM RICHES TO RAGS"

Performance of the Securities Industry in 1989

HIGHLIGHTS

1. Securities industry profitability has drastically declined during the 1980s: pre-tax ROE fell from 50% in 1980 to an average of 7% the last three years while profit margins, well into the double digits in the early 1980s, have averaged under 4% since 1987.

2. Although industry revenues shot up 15% last year to $60 billion, the first real increase since 1986, expenses expanded a greater 17% — net result: a 26% slash in profits to only $1.8 billion, the third lowest showing of the Eighties.

3. Private placements rose over 10-fold in the 1980s to $200 billion and, unlike the public market, showed no signs of slowing down after 1986. Strikingly, privately placed equity, for the first time ever, matched underwritten equity in 1989. Also, private placements raised more money in 1989 than was publicly underwritten before 1986.

4. In almost every quarter since the Crash, Large Investment Banks' profits have equaled or exceeded all other firms' profits combined. Further, in 1989's closing quarter, the LIBs posted a $31 million profit vs a $122 million loss for all other firms.

5. From the Crash through the first quarter of 1989, Regional firms appeared to be riding a one-way profitability bobsled — downhill. But as retail activity returned during the second quarter, Regionals' commissions and profits blossomed and their 1989 pre-tax profit of $215 million doubled their 1988 performance.

6. The trend towards proprietary trading has been one of the most fundamental changes in the securities business since the introduction of negotiated rates. Trading gains, alone, now account for $12 billion, about one-fifth to one-quarter of industry revenues.

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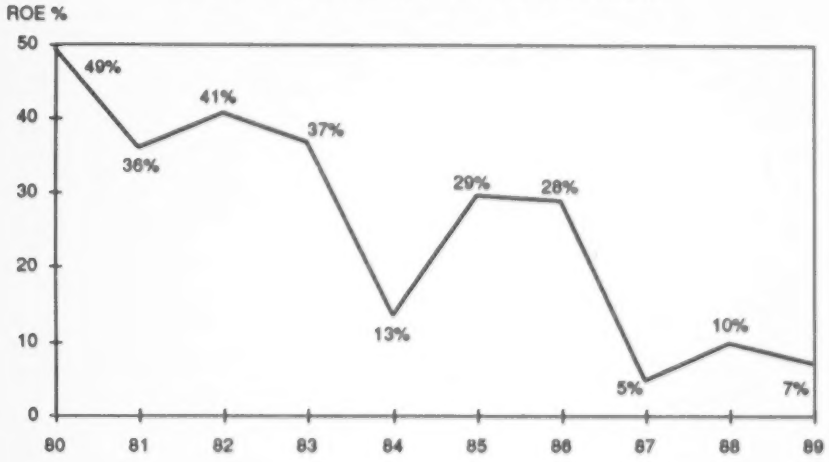
PERFORMANCE OF THE SECURITIES INDUSTRY IN 1989

INTRODUCTION

The securities markets and industry opened the past decade with a roar and ended it with a whimper. It is virtually impossible to think of other industries whose fortunes changed so quickly and greatly. All indicators of industry performance show dramatic changes over the past decade. In 1980, the securities industry earned a pre-tax ROE approaching 50%. In 1989, this same measure of profitability was under 7%. Indeed, from 1987-89, the industry averaged a pre-tax ROE of only 7%. Clearly, under such conditions, securities firms could have fared better by placing their capital in Treasury or corporate bonds which face minimal risk vs the volatile and high risks of the securities industry.

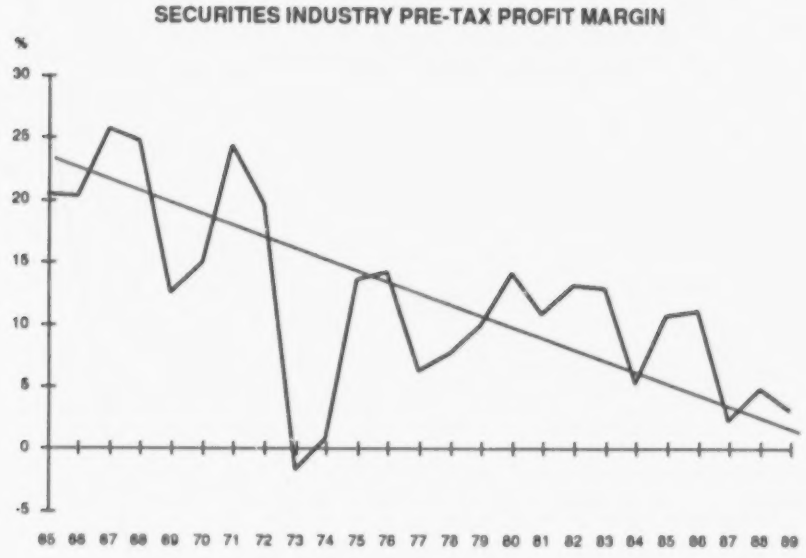
Chart 1

SECURITIES INDUSTRY PRE-TAX R.O.E.



Another key indicator of industry performance also shows a dramatic long-term decline, particularly during the 1980s. In the early part of the decade, profit margins averaged well into the double digits after a long climb back from unprofitability in the early 1970s. During the last few years, such margins were very depressed, averaging 3.7% from 1987-89. Last year, profit margins were 3.1%, the second lowest level of the decade. As Chart 2 suggests, the returns earned in the 1960s when the industry was smaller, agency commission oriented, and protected by fixed commission rates, are probably gone forever.

Chart 2



REVENUES AND EXPENSES

Revenues rose from $16 billion to almost $60 billion for New York Stock Exchange member firms dealing with the public. These revenues are for the NYSE members' broker-dealer units as reported on their FOCUS Reports*; the level of revenues at the holding company is much higher (see Appendix).

This 3.7x revenue increase is certainly impressive. Unfortunately, costs rose even faster: 4.2x, or from about $14 billion to $58 billion by the close of the decade. Last year, we had the first significant jump in revenues in three years — an $8 billion increase to $59.5 billion. Unfortunately, after remaining unchanged in 1987-88, costs spurted more than this $8 billion to a total of $58 billion. This inability to keep costs from rising as fast, or faster, than revenues constantly plagued profitability at securities firms since the industry first showed a rapid pace of growth during the mid-to-late 1970s.

The net result is that pre-tax profits amounted to only $1.8 billion last year, the third lowest showing of the Eighties — only slightly better than 1984's weak performance and crash-impacted 1987. The largest non-interest expense for almost every securities firm is compensation and thus it should be the focal point of any cost cutting and profitability

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* Financial and Operational Combined Uniform Single Report, required of all broker-dealers registered with the Securities and Exchange Commission to be periodically filed with the Commission and with the broker-dealers' primary Self Regulatory Organization, i.e. the New York Stock Exchange or the National Association of Securities Dealers.

analysis. However, even after the severe workforce cutbacks (now approaching 20%) post-crash, per employee compensation continues to rise even as profits plummet (Chart 3). Part of this stems from the fact that the workforce reductions concentrated heavily on trimming low-end producers (leaving the remaining workforce a higher compensated and higher producing group as a whole). On the non-producer side, the reductions also concentrated on the lower cost employee — the bulk of departmental trimming began with staff overcapacity and the first to go were part-timers, temps, etc., but rarely the higher paid department heads or key staff.

Chart 3

Nevertheless, securities industry compensation practices also contribute to this rising expense. Some practices are a holdover from a partnership era, such as firm-wide bonuses often in extreme proportions to profits, or even during periods of losses; and payments to both profitable and unprofitable departments on the premise that the business cycles will even this out in the end (and, with some businesses now possibly permanently unprofitable or marginal, it may not).

Even incentive compensation in the securities industry is almost always tied to how much revenue is generated, not profits, which will just perpetuate the industry's trend of growing revenues and declining profits. Compensation is often irrational, i.e. systems and secretarial personnel working for capital markets may be compensated vastly greater than the same functionaries in operations, even though they basically perform the same function. Also, the industry tends to compensate many functionaries on a higher scale than their counterparts in other industries. Further, firms strive for higher producer compensation in order to retain high producers. The fear, and a justified one, of losing producers to competitors also tends to create payment structures which retain both the unprofitable as well as profitable producers. Again, a revenue driven grid.

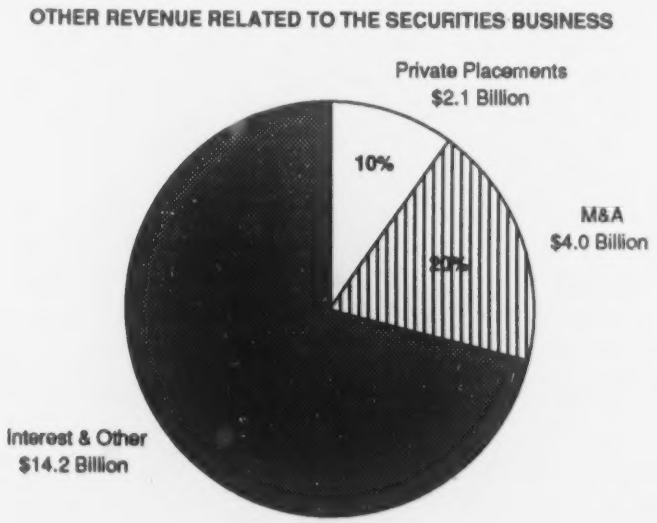
Labor deserves its rewards, as does capital, but as long as securities industry compensation practices stem from the old "partnership philosophy" or revenue as opposed to profit-driven formulas, profitability will continue to suffer. These practices, or the practitioner, will not last long in an industry which remains in a lower margin, more competitive environment relative to earlier years.

Revenues Related To The Securities Business

Last year's $8 billion revenue increase was attributable to the three main categories: commissions, trading and investment gains, and "revenues related to the securities business", although not necessarily in that order. Indeed, significant changes have occurred in the last decade in the relative importance of these three most important revenue categories. Commissions, which accounted for 35% of revenues in 1980, accounted for only 17% by decade's end. Trading and investment gains have undergone the least change in relative importance. These revenues opened the decade by accounting for 23% of the industry's gross; they closed the decade by contributing to 21.5% of total revenues. The most dramatic development has been the explosion in the relative importance of "other revenues related to the securities business," going from less than 11% in 1980 to over 34% by the decade's close.

As noted in earlier issues of Trends and illustrated in Chart 4, this revenue component is comprised mainly of three activities: fees from M&A, fees from private placements, and interest income (sometimes net and sometimes gross). Actually, although this revenue line showed uninterrupted growth during the 1980s, it was during 1987-89 that it had its most dramatic growth — spurting from 19% of gross revenues at year-end 1986, to over 34% by last year. During this time span, this revenue line more than doubled from $10 billion (1986) to $20 billion (1989). At the same time, other revenues were stagnating or coming under increased pressure.

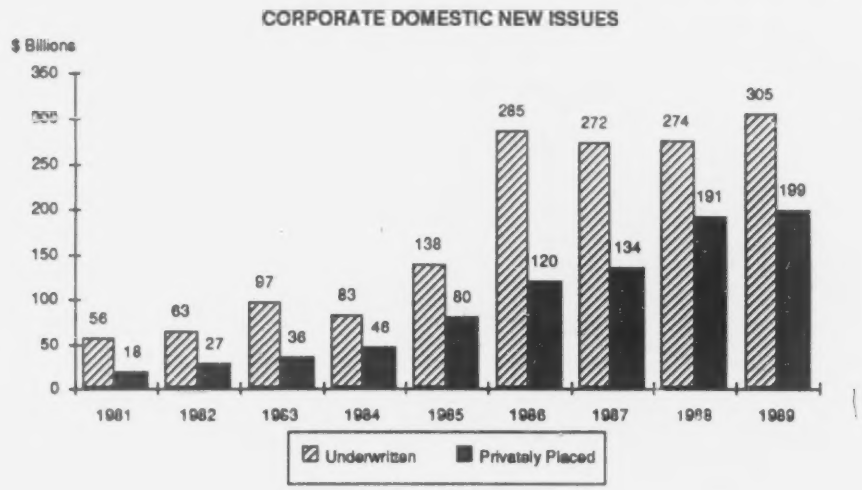
Chart 4



Private Placement Activity

In reviewing the components of revenues related to the securities business, it is apparent that M&A activity and private placements showed dramatic growth during the past decade; particularly, during the last half of the decade. As shown in Chart 5, private placements rose 10-fold in the 1980s from less than $20 billion to almost $200 billion Indeed, while financing activity in the public markets showed signs of slowing down after 1986, there was no such trend in the private placement market. Both debt and equity offerings increased in the private placement market. Strikingly, the amount of equity raised in the private placement market in 1989 matched, for the first time ever, the amount raised in the public markets. Without distinguishing by type of capital raised, the private placement market accounted for about 40% of total funds raised domestically in 1988-89 compared to around 20% in 1980. More money was raised in the private placement market in 1989 than was raised publicly before 1986. The private placement market is now a meaningful competitor to the public markets for entities seeking capital and will be even more so with this Spring's passage of Rule 144A by the SEC.

Chart 5

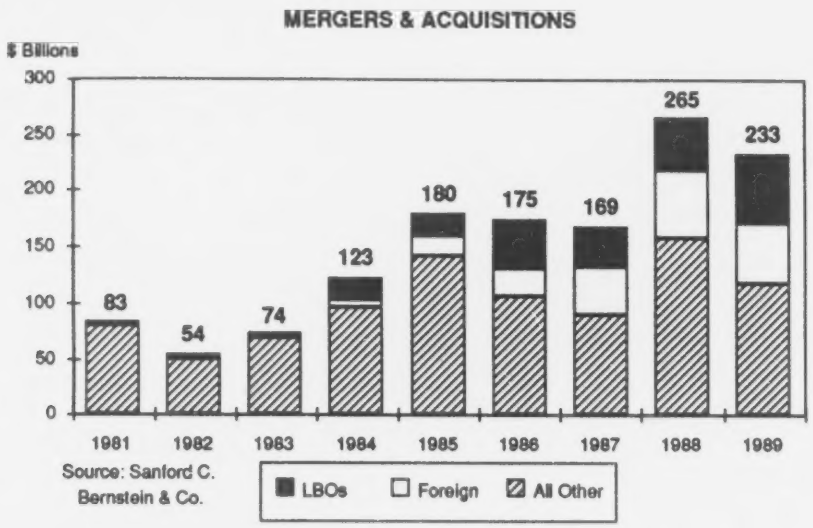


M&A Activity

M&A activity has received more attention from the press, Washington and State Capitals because of its ripple effect on shareholders, employees, vendors, and communities in general. Frankly, however, when it comes to the structure of the U.S. capital market itself, we think what has happened in the private placement market may be a larger and more fundamental change. As expected, M&A activity shows dramatic growth during the past decade from slightly over $80 billion in 1981 to $240 billion last year. Not until 1984 did LBOs become a real factor in this development. With the recent upheaval in the high yield bond market and some of the more leveraged deals in real economic trouble, this trend may have peaked in the 1980s. Again, it appears that the development of the private placement

market with the necessary infrastructure in place may be a more fundamental change to the capital raising mechanism than the more controversial and publicized reorganization of Corporate America through mergers and acquisitions. Although there are substantial fees involved for investment bankers in such activity, there are also greater risks, particularly when their own capital is employed. As Chart 6 shows, the sharp increase in M&A activity also helps explain the dramatic increase in revenues related to the securities business.

Chart 6



Repo Business

The interest component of "other related" revenues is more difficult to estimate; one reason alone is the inconsistent reporting by firms (net vs gross). However, reverse repurchase agreements have grown dramatically on the balance sheets of securities firms thereby generating significantly larger sums of money. At year-end 1980, these securities were valued at $31 billion in assets for the industry; by 1989 they were $220 billion. Meanwhile, repos, as liabilities, grew from $31 billion to $278 billion during the same time frame. This underscores the dramatic growth in the use of these instruments as a means of securities firms raising short-term money for clients and themselves and generating interest income.

OTHER REVENUE SOURCES

Commissions

For the industry, commissions rose 16% last year (Chart 7) as volume on the NYSE increased only 2.5%, from 161.5 million shares daily in 1988 to 165.5 million last year. Most of the growth in commissions was due to an 11% increase in the average price of a share traded from $33.20 in 1988 to $37.00 last year. Other marketplaces also enjoyed increases in the volume of trading and stock prices. For example, daily volume on the Amex expanded

from 9.9 million shares daily in 1988 to 12.4 million shares daily while the average price of a share traded rose from $12.29 to $14.21. On NASDAQ, volume went from about 123 million shares daily to 133 million shares daily, while the average price of a share traded also rose form just above $11 to slightly below $13.

Chart 7

SECURITIES INDUSTRY INCOME STATEMENT

(In $ Millions)

REVENUE:	1988	1989	88 - 89 % Change
Commissions	8,790.5	10,150.7	15.5%
Trading Gains	11,299.1	12,343.3	9.2%
Investment Gains	1,394.2	488.1	-65.0%
Underwriting Revenue	5,158.2	4,120.0	-20.1%
Margin Interest	3,028.5	3,723.1	22.9%
Mutual Fund Sales	1,413.3	1,579.5	11.8%
Fees, Account Supervision	1,884.8	2,225.8	18.1%
Research	23.1	27.1	17.3%
Commodities	1,382.3	1,407.6	1.8%
Other Securities Related	14,693.1	20,337.5	38.4%
Other Unrelated	2,761.9	3,134.4	13.5%
TOTAL REVENUE	51,829.0	59,537.1	14.9%
EXPENSES:			
Total Compensation	18,739.4	18,825.8	0.5%
RR Compensation	7,580.6	7,539.3	-0.5%
Clerical Compensation	9,280.5	9,103.2	-1.9%
Floor Costs	1,756.2	1,855.4	5.6%
Communications	2,548.8	2,374.2	-6.9%
Occupancy & Equipment	3,052.4	3,163.3	3.6%
Promotional Costs	1,003.5	954.6	-4.9%
Interest Expense	16,308.2	24,069.8	47.6%
Errors, Bad Debts	438.1	421.8	-3.7%
EDP	736.6	710.7	-3.5%
Regulatory Fees	371.9	437.5	17.6%
Non-Recurring Charges	56.1	239.8	327.5%
Other	4,325.5	4,642.2	7.3%
TOTAL EXPENSES	49,336.7	57,695.1	16.9%
PRE-TAX NET INCOME	2,492.3	1,842.0	-26.1%

The $10.2 billion in commissions was the third highest during the eighties; while, the $7.6 billion earned on commissions from listed equities was the second highest. Basically, this revenue source could not compensate for the fall off in activity in the listed options area which has remained sharply depressed since 1986-87. The dramatic decline has occurred specifically in options on stock indices which are back to 1984 levels. This pattern is similar to futures on stock indices, particularly the popular future on the S&P 500 index.

The slow recovery in commission revenues is startling when it is widely acknowledged that stock prices performed handsomely since year-end 1987. Since then, the DJIA, S&P 500 and NYSE Composite Index all increased by about 40%. The Amex index has increased by an even higher percentage. Only the smaller capitalized stocks increased at a slower rate, and their increase of 25%-35% is nothing to be ashamed of. Based on these figures, we conclude that the Crash of 1987 left a permanent scar on institutional and individual investors who have chosen to stay on the sidelines with their equity holdings and have turned more and more to fixed income and short-term securities.

Mutual Funds

Sales of mutual funds indicate the change in investor appetite for different securities. In 1970, equities accounted for 81% of all assets in mutual funds with bond income funds comprising the remaining 19%. Then, came the development of money market funds in the late 1970s. By 1980, they accounted for 65% of the assets in all mutual funds. These funds continued to grow in relative importance in the early 1980s, until the explosive growth in equity mutual funds and bond and income funds in the mid-Eighties which continued until 1987. The growth in revenues from mutual fund sales follows the pattern of sales of equity mutual funds and bond funds. There was a slight recovery in 1989 as both equity mutual funds and bond funds recovered some of their earlier popularity. Since 1985, there are more assets in bond and income mutual funds than equity mutual funds.

Proprietary Trading

The trend towards proprietary trading has been one of the most fundamental changes in the securities business since the introduction of negotiated rates. As the profitability of the agency business declined, securities firms turned to other business activities to bolster their profitability. One of the most natural was taking principal positions in securities. Bond trading gains (losses) and OTC market making dominates this activity. Other trading activities, such as arbitrage and other niche trading specialities, have also come into their own during the last few years. In total, trading gains have grown to a $12 billion business and account for about one-fifth to one-quarter of industry revenues.

Also showing impressive and steady growth from 1980 until 1987 was investment gains for firms' own accounts. However, the post-crash world has demonstrated just how volatile taking positions in companies can be. The less than $500 billion earned last year was the second lowest figure for the decade as many earlier deals turned sour. The natural procession of the industry from acting as agent, to taking positions in securities, to taking positions in companies has not been without risk as some of the latest LBO deals demonstrate vividly.

Money Management Fees

Despite the risks taken by the industry in the proprietary field, it has been very successful in attracting funds to manage, a much less risky, but nonetheless extremely competitive field. Fees from money management activities have grown from $175 million to $2.2 billion last year. The strategy of collecting assets and managing those assets while moving away from transaction fees seems to be working and is counter-cyclical to other more volatile revenue sources. This growth has been similar to the revenues related to the securities business without the same volatility and with different firms being the major factors as noted later in this report.

EXPENSES

It is clear from the decline in profit margins that the growth or expansion of expenses exceeded revenues during the 1980s. At the beginning of the decade, expenses amounted to less than 86% of revenues. During 1989, expenses ate up just under 97% of revenues. The cost item that has accounted for most of the increase in expenses relative to revenues is interest , which grew from $3.4 billion in 1980 to over $23 billion in 1989. As a percentage of revenues, interest expense has about doubled, from 22% in 1980 to 40% last year. Although FOCUS interest reporting doesn't allow for analysis of net interest income, and there have been periods of strong profits from this area, it is still obvious that if the securities industry could find a way to lower or cut interest expense, this would mean a significant change in profitability and deserves intense study by firms.

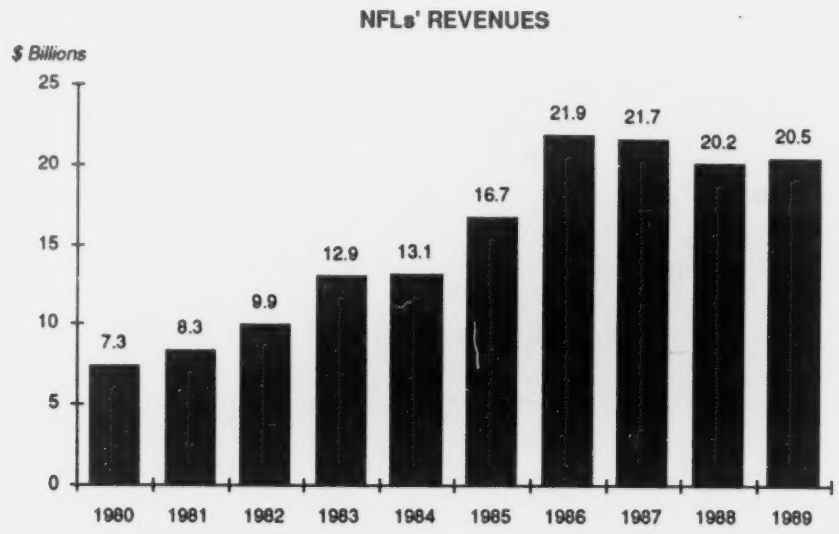
Until last year, interest expense was second to compensation as the largest cost component. Compensation expenses have declined from almost 40% of revenues to about 32% of gross. The decline only occurred during the past two years and much of it is due to the drop in RR compensation as a byproduct of a drop in gross production or in other words, a drop in their revenues. Indeed, until 1987, RR compensation exceeded compensation to other employees. This relationship changed abruptly in 1988 and continued last year as clerical compensation exceeded RR compensation by almost $2 billion annually. Also, as noted earlier, much more work is needed on industry compensation practices beyond headcount reduction in order to tackle declining profitability.

There are other expenses that continue to trouble the industry relative to revenue growth. Communication costs have declined only slightly relative to revenues going from 5.2% in 1980 to 4% during 1989. Meanwhile, occupancy and equipment cost rose from 3.2% of revenue to 5.3% last year. Because of the dramatic growth in interest expense relative to revenues, almost every other cost line shows a relative decline with respect to revenue growth. This should not be interpreted that during the 1980s, firms had a firm handle on controlling expenses. To the contrary, it appears that, for the most part, the industry remains mainly revenue driven and market share oriented. In part, we believe this is attributable to the great difficulty in estimating account and product profitability because of the many assumptions involved in allocating joint costs and facilities among different products and services.

NATIONAL FULL LINE FIRMS

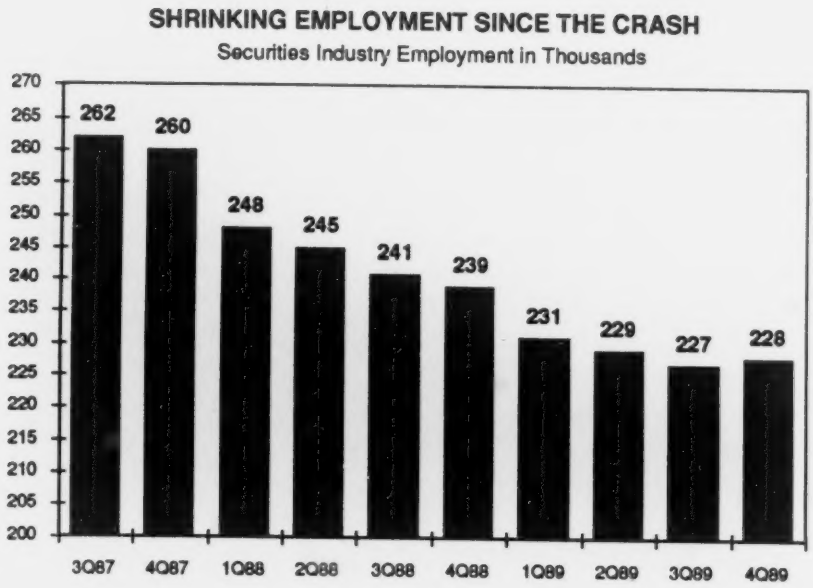
Total revenues for the National Full Line firms (NFLs) improved only fractionally last year but is still below their peak levels of 1986 and 1987 (Chart 8). Although these revenues are for the NFLs' broker-dealer units, the NFLs' holding company revenues, while twice as large, have also shown little or no growth in recent periods. The NFLs' revenue stagnation is the result of several factors. First, there has been some consolidation within the group: 1989 results (from which this data is derived — see Appendix) no longer include E.F. Hutton, though some of its former activity is still reflected in Shearson.

Chart 8



Second, many of the NFLs' main business lines have been under constant pressure since the Crash, i.e. retail, mutual fund sales, etc., and so the NFLs have also been consolidating intra-firm — scaling back operations to reflect the lower level of business. Hundreds of branch offices have been closed or consolidated; back office functions have been scaled down, and correspondent clearing services have even been dropped by a major NFL firm. The bottom line shows employment is down 15% at the NFLs since the Crash, from 150,000 just prior to the Crash to 128,000 at 1989's close. This group, comprising the bulk of the industry's overall as well as retail employment (about 60%), also has absorbed the bulk, 64%, of the industry's workforce cutback (industry cutback shown in Chart 9). Obviously, the levels will be down even further in 1990 with the loss of several firms, Drexel, Thomson McKinnon, etc., and further cutbacks announced at other NFLs.

Chart 9



Commissions, one-fifth of the NFLs' revenue stream, hovered around $1 billion per quarter in 1989, below 1986-87 levels but still above 1988 or 1985 commissions. Trading gains of $5.1 billion matched 1988's level and were second only to 1986's record $5.5 billion. However, during the second half of 1989, trading waned somewhat, mainly from woes in the junk bond market.

One area severely hit: gains from firm's own investment accounts. This fell 90% last year to only $20 million, the third lowest of the decade, and there was even an absolute loss of $17 million in the fourth quarter. A good portion of this reflected losses from equity positions in prior LBO deals gone sour. Underwritings, which got off to a horrendous start in the first quarter, only improved slightly for the balance of the year with a net result of $1.8 billion, the lowest underwriting revenue for this group since 1984, itself an off-year.

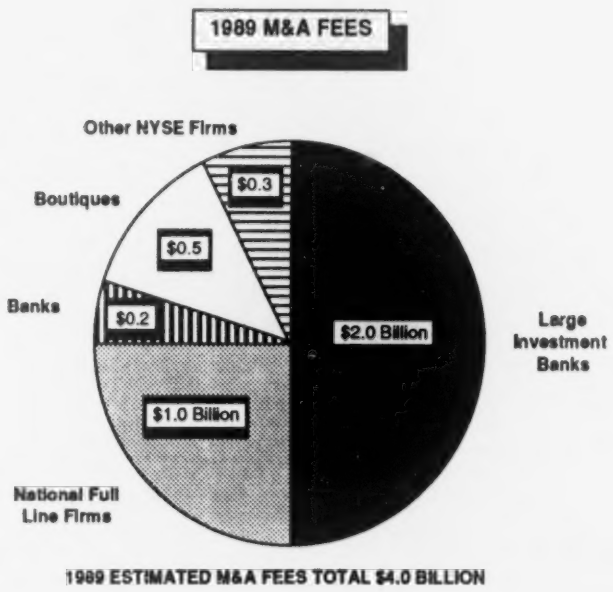
Margin interest climbed to a record $1.8 billion, even exceeding underwriting revenues, a rare occurrence in recent years. However, it wasn't that lofty a record since margin revenues have steadily earned between $1.2 billion and $1.7 billion annually throughout the Eighties, a time when total revenues tripled for the NFLs. Also, the publicly held NFLs all had hefty net interest income at the holding company level, although the largest firms showed some slippage from their year-earlier results.

Mutual fund sale revenues improved about 10% last year to $1.2 billion, but this still only matches 1985's results and falls far short, nearly half, of the NFLs' record $2 billion generated in 1986. One bright spot has been asset management fees. This area continued its explosive growth of the 1980s, with consecutive new highs substantially exceeding the

previous year's record. Last year, NFLs' asset management fees broke the billion dollar barrier rising a whopping 44% to $1.2 billion (with substantial additional amounts generated outside the NFLs' broker-dealer units).

Still, asset management is dwarfed in importance by the "Other Revenue Related to the Securities Business" line, which reflects the "hot" areas of M&A, private placements and repo interest. Here the news was bad for the NFLs. Bucking the industry trend, the NFLs again showed a decline in this area, with revenues now down to only $3.5 billion, the lowest showing since 1985. Part of this drop came from lower M&A fees and the fact that the NFLs are not the powerhouses in the M&A area as are the LIBs. Only Drexel, Merrill and Shearson have a significant presence and Drexel, the biggest of the three in this area, is now gone. NFLs earned $1 billion in M&A fees last year (Chart 10), half of the LIBs' earnings and 29% of the NFLs' "other related" revenues.

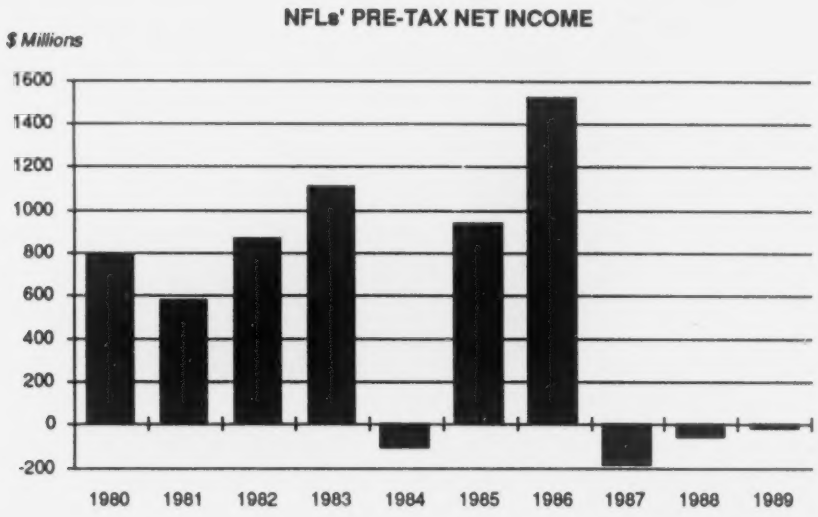
Chart 10



Similarly, of the NFLs, only these three firms plus PaineWebber have a significant share of private placements fees. All told, NFLs have about $900 million in fees from this area, the same as money center banks but slightly less than the LIBs' $1.2 billion. Last year, private placements accounted for one-quarter of the NFLs' "other related" revenues. Finally, the biggest factor in the NFLs' declining "other related" revenue is a two-thirds reduction in the group's repo and reverse book (and related interest) resulting from a merger.

The bottom line from these revenue problems: 1989 was the third consecutive year in which NFLs broker-dealers have posted losses, although the red ink is getting smaller (-$193 million in 1987, -$68 million in 1988 and -$25 million last year — see Chart 11). However, these losses are in the broker-dealer units while NFLs' holding company results, while still poor, were not in the red for any of these years (see Appendix).

Chart 11



It's not just poor revenue performance penning this red ink. Expenses at the NFLs doubled from 1983 to 1986 and have not been curtailed to any extent since. Interest expense returned to record levels last year at $4.6 billion, and accounted for a record 22.3% of total revenues. This is tempered somewhat by the belief that the NFLs also earned positive net interest income at the holding company level, although FOCUS reporting does not allow for this type of analysis. For the publicly-held NFLs, the holding companies reported strong net interest income although somewhat below 1988's levels.

Also a contributor was occupancy & equipment expense which continues to climb to record levels. However, although record costs have been posted every year, the growth was finally slowed — less than 2% growth in 1989 vs 8% in 1988, 24% in 1987 and 16% in 1986. Meanwhile, communication costs were trimmed slightly to pre-1987 levels but EDP costs hit a new high.

Non-recurring charges exploded seven-fold to, by far, a new record $182 million, most likely attributable to Merrill Lynch's fourth quarter restructuring charges including employee termination costs. Again, FOCUS fails us — at the holding company level, Merrill reported a $470 million pre-tax restructuring charge which means, at best, only a third of the total was reflected in FOCUS. This new record is assured of quick extinction since Shearson just announced a first quarter restructuring charge of $650 million (although just how much will filter down to FOCUS is unknown).

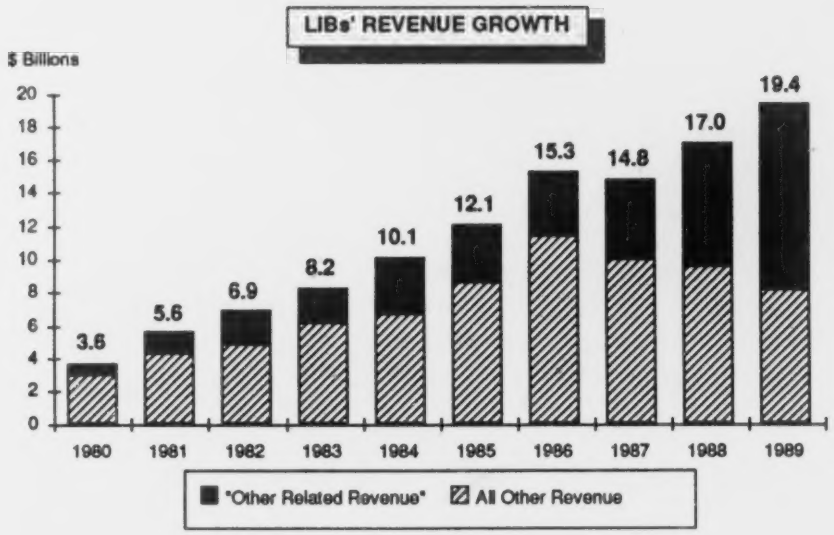
The only bright news on the expense side of the ledger was compensation costs. For the second year in a row, the NFLs' compensation costs were reduced, last year by 6% to $9 billion, the lowest level since 1985 and a full 15% below 1987's record $10.6 billion total. That compares with an 11% cut in total employment from 1987's peak. Both RR and clerical compensation were also at their lowest levels since 1985. Nevertheless, the NFLs also

suffer from a rising comp per employee trend as seen earlier. Total comp is down because of the total cuts but we would be much more optimistic if there were improvement in compensation costs within the remaining workforce.

LARGE INVESTMENT BANKS

With the exception of crash-impacted 1987, Large Investment Banks (LIBs) set revenue records every year during the 1980s. Last year, revenues rose 14% to $19.4 billion (also 14% at the holding company level, to $31 billion — see Appendix). Last year's $2.4 billion increase in revenues was more than accounted for by a $3.7 billion, or 50%, increase, in "Other Revenue Related to the Securities Business." As mentioned, the "hot" areas of M&A, private placements and interest income have been driving the industry's, and particularly the LIBs' growth. In fact, this area is now two-thirds of the LIBs' total revenues, up from less than 20% back in 1980, and last year's "other related" revenue exceeded the LIBs' total revenues only five years ago. As Chart 12 illustrates, revenues from other sources (particularly trading) have actually declined since peaking in 1986.

Chart 12



However, we estimate that of the $11.2 billion in "other related" revenues earned last year, $2 billion, or 18%, was from M&A fees. That compares with $2.5 billion in M&A fees in 1988. As shown earlier, completed M&A deals fell from a record $265 billion in 1988 to $233 billion last year while total fees earned from these deals fell from $4.5 billion to $4.0 billion.

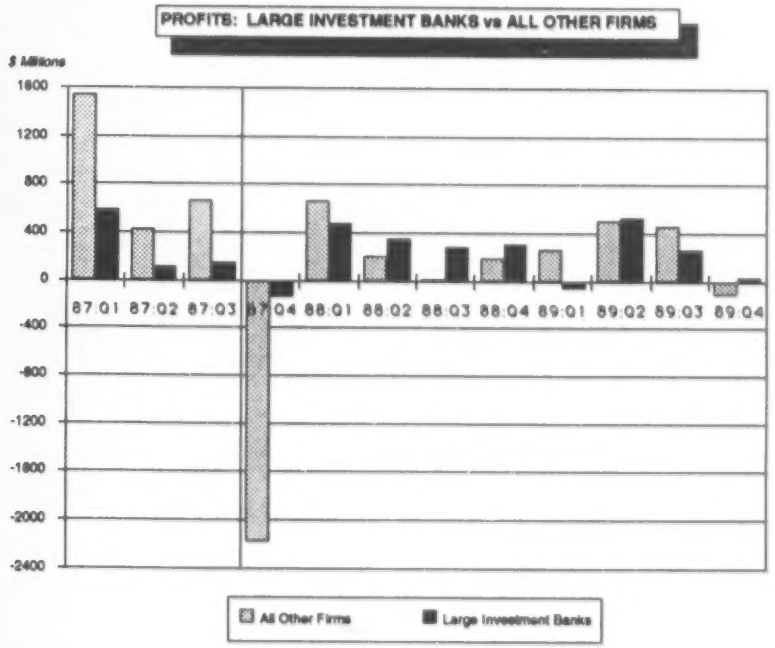
Meanwhile, the LIBs were lead agents on about $80 billion of the record $200 billion of domestic private placements last year, or 40%. This was a slight drop from their 45% share, or $86 billion, of 1988's $190 billion private placement market. We estimate that the fees earned in this area totaled $1.2 billion for the LIBs or 11% of their "other related" revenues. The balance, or 71%, of this line is assumed to be mainly interest revenues. As noted below, the LIBs are assumed to have collectively earned substantial net interest income.

Although last year's trading gains of $3.8 billion matched 1988's level, this still fell far short of 1986's record $5.2 billion. This area accounts for a good portion of the drop off in "all other" revenues as seen in Chart 12. The LIBs' bond trading gains were stronger in the first half, prior to the souring of the high yield market.

Last year, the LIBs also had their worst underwriting performance in five years. The $1.5 billion booked in 1989 represented a 17% drop from 1988's showing. LIBs' asset management fees fell for the first time last year, down 26% or $104 million, to $295 million. Although this drop ostensibly bucks the industry trend, it was the result of at least one and possibly two LIBs shifting sizable asset management operations out of the broker-dealer.

Margin interest hit a record $687 million, a 41% increase over 1988's showing. The flip side shows interest expense once again headed to the stratosphere, logging in at $11.5 billion, a 33% increase and so large a factor that 60% of revenues are now used to cover interest payments. Interest expense's $2.8 billion increase also accounted for nearly the entire $3.1 billion increase in total expenses. However, for at least some LIBs the net result was good. Two of the three publicly held LIBs' holding companies showed strong net interest income while the third showed the opposite, a strong net expense.

Chart 13



For yet another post-crash quarter, the LIBs dominated the industry's profitability scene. In last year's closing quarter, the LIBs posted a $31 million pre-tax profit. While small and substantially down from the previous two quarters, this profit compares to a $122 million loss for all other firms as a group. Of course, the NFLs' fourth quarter loss of $131 million, alone, offset profits from other firm categories. Still, as can be seen in Chart 13, LIBs have equaled or surpassed all other firms profits quarterly since the Crash.

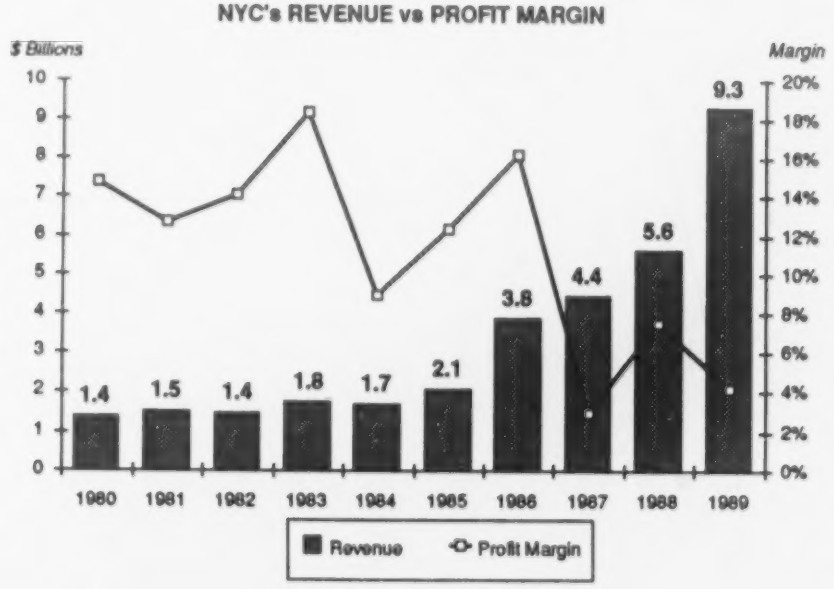
Even though the LIBs remain profitable and showed a healthy 14% revenue growth in 1989, there is no absence of profit pressure with expenses continuing to mushroom. Total expenses climbed a much higher 20% in 1989, halving profits from 1988's $1.4 billion to $750 million last year. In fact, all expenses climbed except communications and EDP costs while interest expense alone rose almost $3 billion.

NEW YORK CITY-BASED REGIONALS

In the early 1980s, the NYC-based Regionals closely mirrored their regional brethren scattered throughout the 50 states. Commissions were about half of their revenues with other sizable contributions coming from trading, margin, underwriting, etc. This rapidly changed during the late 1980s and this group now closely mirrors the LIBs, albeit on a smaller scale. Commissions are only 13% of total revenues, while principal transactions account for one-quarter. And like the LIBs, other and other-related revenues (M&A, private placements and particularly interest income) account for more than half of all revenues.

This group of about 80 firms has shifted its business emphasis more to the institutional side and active principal businesses with a fantastic growth in revenues. Total revenues hovered between $1 and 2 billion annually through 1985, before the business line shift, and then exploded, finally reaching $9.3 billion last year. However, as Chart 14 demonstrates, that growth doesn't necessarily translate into higher profitability.

Chart 14



The past two years have witnessed much of this growth. During this time, assets more than doubled from around $40 billion to $90 billion. Half of this growth came from a doubling of the reverse repo book to $50 billion — nearly half of all assets and a leading contributor to the growth in the "other related" revenue line. On the other side of the ledger, repos grew even faster to $60 billion, two-thirds of total liabilities.

This growth was leveraged since total capital increased only $1 billion over the past three years to $4.5 billion, the number of firms remained at about 80, while employment hovered around 15,000 (basically the only group of firms not to have undergone any downsizing since the Crash).

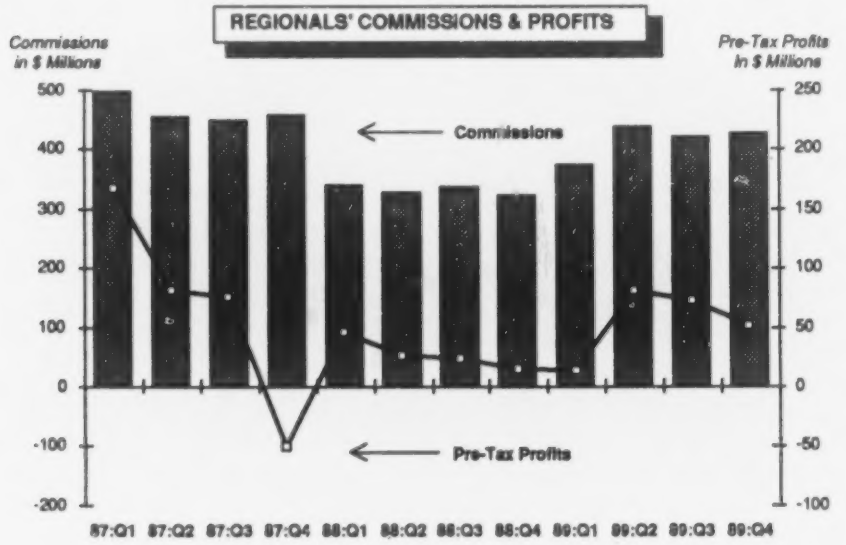
These firms make up just under one-quarter of all NYSE firms and their growth has vaulted their share of industry revenues from 9% in 1987 to 16% last year. The new reliance on interest income has translated into a 25% share of all interest expense in the industry, second to the LIBs' 47% share and drastically larger than Regional firms' 2% share. Also, the 143% increase in interest expense last year was entirely the cause of a 71% increase in total expenses. This outstripped revenues growth of 65%, impressive as that is, for a 7% drop in profits to $386 million.

A final note, the 31 "Large New York City-based" firms, just under 40% of the group's total, dominate 80% to 90% of the groups' revenues, profits, capital, assets and employment.

REGIONALS

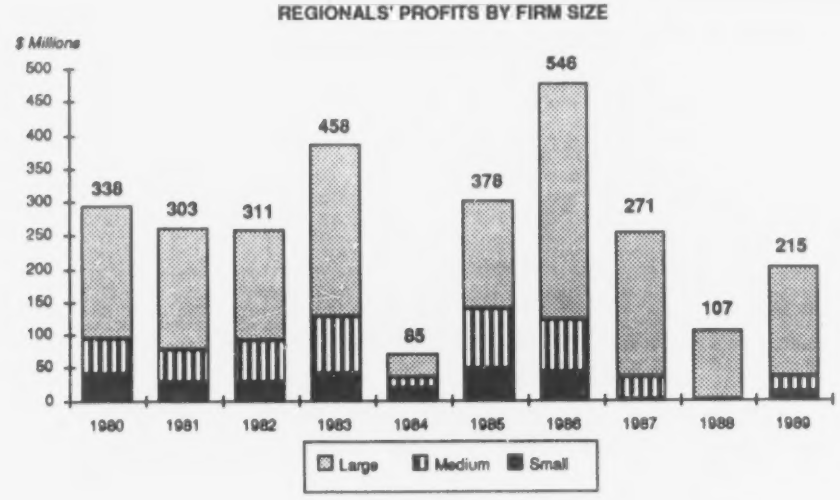
From 1987 through the first quarter of 1989, Regional firms appeared to be riding a one-way profitability bobsled — downhill. Then, beginning in 89:Q2, retail activity began to pick up to the best levels since the Crash (but not quite up to the record levels immediately preceding the Crash) and profitability hopes sprung anew. However, for the remainder of the year, profits again waned but never down to the anemic levels of 1988 . The Regionals' profitability levels closely track their level of commission business (Chart 15), one-third their total revenue stream; many Regionals have been trying to diversify their revenue base to avoid this commission dependence.

Chart 15



This small return to profitability was not evenly enjoyed by all Regional firms. Some Regionals showed record profits during certain quarters of 1989 while other Regionals went into receivership or closed. As Chart 16 shows, in general, Large Regionals (revenues exceeding $70 million) have fared the best since the Crash while both Small Regionals (revenues under $20 million) and Medium Regionals ($20 to $70 million of revenues) returned to modest profitability last year.

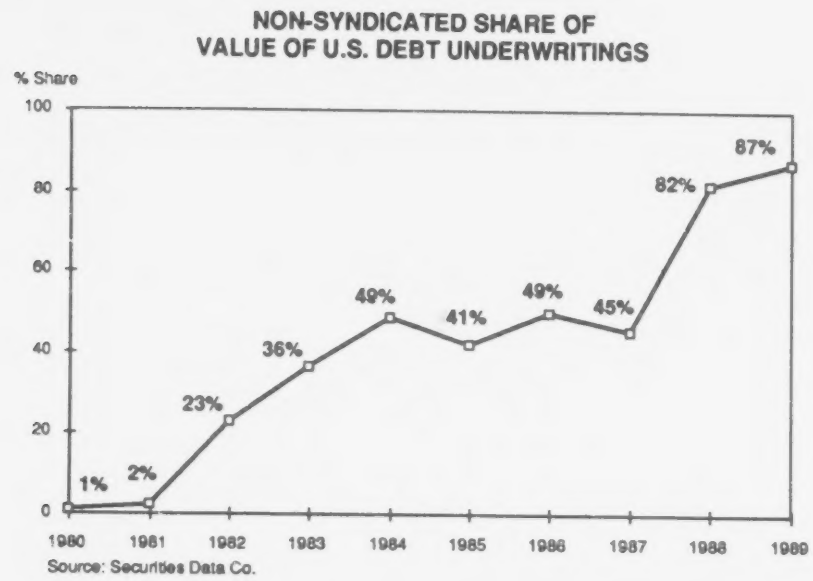
Chart 16



Commissions, still one-third of Regionals' total revenues, rose a solid 25% last year reflecting renewed retail investor interest and bettering the industry average of a 16% increase in commission revenue. Trading gains improved 11% vs 9% for the industry as a whole. These two lines taken together represent the majority, over 53%, of Regionals' revenues.

Underwriting income, about one-eighth of total revenues, held even last year for the Regionals vs a 20% decline industry-wide. However, the decline in M&A related underwritings, high yields and other mega deals does not impact the Regionals to any extent since these deals are no longer syndicated to the Regional level. In fact, 1982's passage of the shelf registration rule by the SEC, Rule 415, effectively signaled the end of most bond syndications as is seen in the Chart 17.

Chart 17



Conversely, the Regionals' absence from the M&A and private placement areas left them with a 10% rise in "other related" revenue vs a 38% rise for the industry. Also, this line is only one-eighth of Regionals' total revenues vs one-third for the industry. Other retail areas showing improvement were asset management fees, up 18%, and margin interest, up 23%.

Put together, total revenues rose 17%, a good sign since the industry's 15% average increase was totally dominated by the LIBs' performance. Combining this revenue growth with a slower, less than 15%, increase in costs, Regionals' profits doubled last year. Although that compares to a 26% decline in profitability for the industry (pushed down by the NFLs), we noted earlier that Regionals' profits last year peaked during the second quarter.

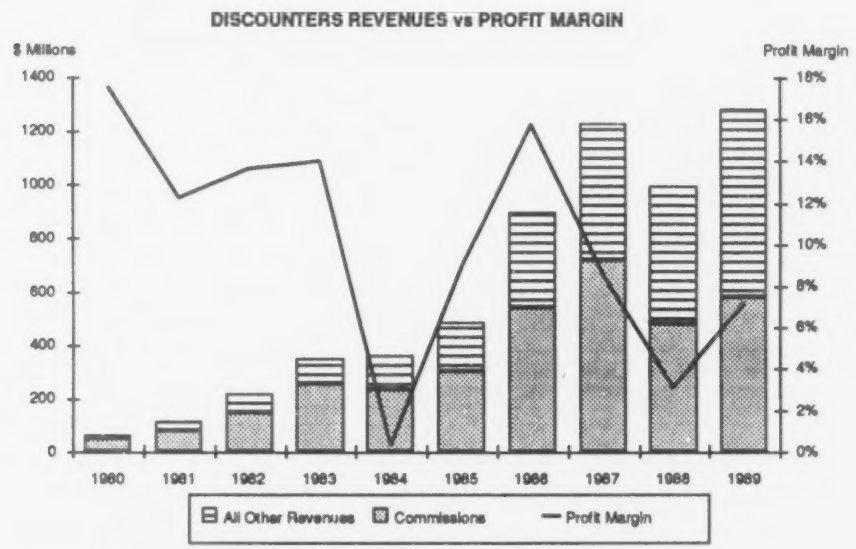
DISCOUNTERS

Discount broker-dealers which are members of the New York Stock Exchange number only about two dozen and their aggregate financials are heavily weighted by a few national discount firms. Even when analyzing the larger universe of all NASD members and their discount brokerage membership, the national discounters still account for about half of many of the aggregate figures.

For most of the 1980s, up until the Crash, Discounters' commissions accounted for about two-thirds to three-quarters of their entire revenue base. Since the Crash, this has fallen to just under half. For the past two years, trading has accounted for an additional 13%, margin interest 17%, and surprisingly, "other related" revenue skyrocketed to 23% last year vs less than 3% back in 1980.

Despite the growth in revenues, and even commissions, Discounters have suffered the same deteriorating margins in the securities business as other firm categories as seen in Chart 18. However, being more commission and retail dependent, the swings, both up and down, in profitability are steeper for this group as retail clients become active or inactive. Also, the cost structure is quite different for this group. Their compensation practice, to work almost exclusively with salaried personnel (only 3% of costs are broker compensation) has kept their total compensation expense at around 25% of revenues throughout the 1980s. Discounters have moved into some institutional areas and the correspondent clearing business and their interest expense has climbed to 24% of revenues from just 3% in 1980.

Chart 18



Still, this niche playing has garnered Discounters an important share of the retail business, about 8% to 9% of retail commissions in recent years. For a further analysis of this group and its' market share, a future issue of Trends on Discounters will be published later this year.

CONCLUSION

The securities industry's constant cost problems, shrinking margins, competitive pressures and the resultant low profitability have created a condition where, clearly, the industry could have fared better by placing its capital in riskless Treasuries and avoided the volatile and high risks of the business today. The high profitability the industry once enjoyed from being a small and somewhat protected (fixed rates) agency business years ago are probably gone forever.

Capital is the name of the game and nearly two-thirds of the industry's revenue stream is derived from businesses where capital is at risk, i.e. trading, underwriting, merchant banking, etc. Though margins are low, it still has been these risk-based businesses, and

firms concentrated in them (LIBs, NYCs), that have shown the highest returns in recent years. These businesses carry with them, however, the intendant risks of higher loss along with higher rewards. In such an environment risk controls and cost controls are of paramount importance to profitability and success.

When it comes to costs, compensation and interest expense are by far the two largest components for most securities firms. As a percentage of revenues, interest expense has about doubled, from 22% in 1980 to 40% last year. Although FOCUS interest reporting doesn't allow for analysis of net interest income, as mentioned earlier it is still obvious that the securities industry could improve profitability substantially by lowering its interest expense and cost of capital.

Likewise, although there has been some progress in rolling back compensation costs at some firms, much more needs to be done in this area. Incentive compensation should be tied to profitability as opposed to gross revenues generated. Rational compensation plans should be instituted and maintained which compensate similar functions with similar pay, regardless of the departmental lines they report to. Incentive plans should be geared toward keeping profitable producers and these should be based on profitability measures and not merely gross revenue parameters without regard to the firm's bottom line.

Finally, the 1990s pose many difficult challenges to securities firms and their management. At the same time, it should offer many opportunities to those who can steer a steady course with one eye to the horizon and the other to the bottom line.

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George R. Monahan
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APPENDIX

FOCUS Reports

The shortcomings of securities industry financial data in general, and of the FOCUS Report in particular, are many and have been frequently illustrated in Trends issues throughout the years. The first problem is the availability of a uniform source of financial data on a mainly privately-held industry. Although there are many more large publicly-held brokerage firms today than a decade ago, stockholder-owned brokerages still only number a few dozen out of the thousands of registered broker-dealers.

Chart A-1

NYSE GROUP'S SHARE OF TOTAL INDUSTRY*
(In Percent)

Item	1980	1981	1982	1983	1984	1985	1986	1987
Revenues	80	81	81	80	79	77	78	77
Assets	85	78	86	86	88	87	87	85
Capital	65	66	70	71	71	71	71	76
Equity	63	65	69	69	68	68	69	72
# of Firms								
NYSE Group	389	390	387	412	393	381	417	395
All Firms	5,283	5,714	6,165	7,374	8,272	8,957	9,436	9,196

* Total industry based on data from the SEC Monthly Statistical Review, August 1988.
NYSE Group: New York Stock Exchange member firms doing a public business.

The only uniform source of financial data on the securities industry is the FOCUS Report, including income statements and balance sheets, which the SEC requires all broker-dealers to file. Unfortunately, the SEC no longer publishes FOCUS information on the securities industry. SIA and the New York Stock Exchange jointly maintain a database on the quarterly performance of NYSE member firms doing a public business based on aggregate information from this group's FOCUS reporting to the NYSE. As Chart A-1 indicates, through 1987 (last reported year before the SEC discontinued FOCUS publishing), this NYSE group, although small in number, accounted for a majority of the securities business and have been a sufficiently representative group to be used as a proxy for the "total industry." In fact, there currently exists no viable alternative to this "Securities Industry Database."*

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* The "Securities Industry Database" contains quarterly and annual income statements and balance sheets from 1980 to the present on aggregate groups of NYSE member firms including, National Full Line Firms, Large Investment Banks, Regional Firms, Discounters, etc., and is available on a subscription basis from SIA's Research Department: (212) 608-1500.

Another problem with FOCUS Reporting is that its categoric breakdown of data was designed in the 1970s which no longer meets the realities of the 1980s. It will surely become hopelessly meaningless during the 1990s. For instance, 40% of the "industry's" revenues in 1989 met none of the main FOCUS reporting categories and were designated as "other revenue," either other related to the securities business or other unrelated. The problem is worse for certain firms such as Large Investment Banks where these "other" categories account for 59% of total revenue (Chart A-2). For any meaningful analysis, FOCUS could sorely use reporting lines for many of today's important businesses such as M&A fees, bridge loans, net interest or even gross interest income, private placement fees, etc.

Chart A-2

"Other" Revenue's Share of Total Revenue*
(In Percent)

Firm Category	1980	1989
National Full Line Firms	9.5	21.4
Large Investment Banks	24.3	59.0
Regionals	9.2	17.2
New York City Based	17.3	53.9
Discounters	17.3	31.1
Total Industry*	**14.5**	**39.5**

*Includes both "other related" and "other unrelated" revenue lines.

A third problem is that for those firms for which we are able to obtain data, the NYSE group, we must rely on FOCUS data which only covers the domestic broker-dealer units of securities firms. For the vast majority of brokerages, i.e. the smaller regional firm, this is not a major problem since the broker-dealer is, in most cases, the entire securities firm. However, the securities industry is dominated by large, national firms and investment banks (Chart A-3) where the broker-dealer accounts for only a fraction of the holding company's business.

Chart A-3

SECURITIES INDUSTRY* CONCENTRATION
(In Percent)

Total Revenues	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Top 10	52.9	55.5	57.4	54.3	58.8	57.5	57.3	54.5	54.0	58.5
Top 11-25	20.1	19.5	18.7	19.6	17.1	19.7	19.8	20.9	20.8	19.3
Rest of Industry	27.0	25.0	23.9	26.1	24.1	22.8	22.9	24.6	25.2	22.2
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Revenues ($ Bils.)	16.0	19.8	23.2	29.6	31.2	38.6	50.1	50.8	51.8	59.5

Total Capital	**1980**	**1981**	**1982**	**1983**	**1984**	**1985**	**1986**	**1987**	**1988**	**1989**
Top 10	50.7	52.6	54.8	52.9	57.3	63.2	61.9	58.3	57.5	61.8
Top 11-25	18.8	19.6	19.0	18.8	15.7	14.8	16.0	18.5	17.8	16.4
Rest of Industry	30.5	27.8	26.2	28.3	27.0	22.0	22.1	23.2	24.7	21.8
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Capital ($ Bils.)	6.7	8.1	10.7	14.2	16.7	21.9	29.8	35.8	39.1	39.3

* NYSE member firms doing a public business

Some holding company businesses do not directly relate to securities — i.e., real estate, mortgage banking, leasing and insurance — but a good portion of holding company non-FOCUS revenues are securities related such as M&A-related, asset management, and overseas securities activities.

For the publicly held NFLs, 51% of their holding company revenues are not reported in FOCUS, up dramatically from 35% as recently as 1985. A smaller, but still large, 38% of publicly held LIBs' revenues are also not reflected in FOCUS, up from 34% in 1985.

Since these two groups collectively account for over two-thirds of all NYSE FOCUS revenues, the magnitude of the amounts escaping industry analysis is quite obvious. Further, though most small regionals have almost all of their operations within the broker-dealer, analysis of some larger, publicly held regionals' holding companies vs. FOCUS indicates that about 10% of all other firms' revenues are also not reflected in industry FOCUS analysis. The net result is an industry average of 40% of all revenues not shown in FOCUS.

Profitability levels are even more skewed by FOCUS. The NFL group's FOCUS showed losses for the past three years while their holding companies have consistently shown profits. Further holding company analysis illustrates the large difference in revenues and profits between the securities firm holding companies and their broker-dealer units (Chart A-4).

Chart A-4

NYSE Broker-Dealer 1988-89 FOCUS Reporting vs. Estimated Holding Company Total Results

(In $ Millions)

	1988		1989	
	FOCUS	Estimate	FOCUS	Estimate
NFLs				
Revenues	20,167	41,157	20,467	41,769
Pre-Tax Profits	-68	1,733	-25	376
Profit Margin	-0.3%	4.2%	-0.1%	0.9%
LIBs				
Revenues	17,049	27,498	19,410	31,306
Pre-Tax Profits	1,433	3,178	748	2,630
Profit Margin	8.4%	11.6%	3.9%	8.4%
All NYSE Firms				
Revenues	51,829	84,895	59,537	99,228
Pre-Tax Profits	2,492	6,161	1,842	4,250
Profit Margin	4.8%	7.3%	3.1%	4.3%

Despite these shortcomings, FOCUS data remains the only viable source for securities industry profitability analysis. However, the reader should keep in mind that Trends analysis of securities industry profitability refers only to NYSE member firm broker-dealers.

VOLUME

	APR. 1990	YTD 1990	APR. 1989	YTD 1989	% CHG YTD 1990-1989
AVERAGE DAILY SHARE VOLUME ON					
NYSE (MILS.)*	140.1	154.5	161.9	164.7	-6.2%
AMEX (MILS.)*	14.1	14.4	11.5	11.4	26.9%
NASDAQ (MILS.)*	129.6	131.8	133.3	131.7	0.0%
REGIONAL EXCHANGE (MILS.)*	22.7	24.9	25.8	26.3	-5.4%
DOLLAR VALUE OF SHARES TRADED ON					
NYSE (MILS.)	$95,756	$443,627	$115,480	$474,978	-6.6%
AMEX (MILS.)	3,403	13,855	3,605	12,508	10.8%
ODD-LOT SHARES PURCHASED ON NYSE (THOUS.)	8,644	37,076	9,644	35,477	4.5%
ODD-LOT SHARES SOLD (INCLUDING SHORT SALES) ON NYSE (THOUS.)	12,851	56,853	16,265	66,602	-14.6%
NYSE BLOCK VOLUME AS A PERCENT OF TOTAL SHARES TRADED	49.4%	49.8%	52.0%	52.6%	----
CONTRACTS TRADED (THOUS.)					
CBOE OPTIONS	9,486	41,896	9,644	41,842	0.1%
AMEX OPTIONS	2,656	12,353	3,305	13,310	-7.2%
COMMODITY	20,838	93,074	21,902	88,366	5.3%

*MONTHLY AVERAGE
N/A - DATA NOT AVAILABLE

PRICES
(END OF MONTH)

	APR. 1990	APR. 1989	% CHG APR. 1990-1989
DOW JONES INDUSTRIALS	2656.76	2418.80	9.84%
STANDARD & POOR'S 500	330.80	309.64	6.83%
NYSE COMPOSITE	181.49	173.13	4.83%
AMEX MARKET VALUE INDEX	343.10	345.08	-0.57%
VALUE LINE COMPOSITE	232.24	254.58	-8.78%
NASDAQ COMPOSITE	420.07	427.55	-1.75%

YIELDS
(MONTHLY AVERAGES)

	APR. 1990	APR. 1989	BASIS POINT CHG 1990-1989
BOND BUYER INDEX (20 BOND)	7.39%	7.49%	(10)
CORPORATE BOND YIELDS (MOODY'S)			
Aaa CORPORATE	9.45	9.79	(34)
Baa CORPORATE	10.29	10.61	(32)
RATIO Aaa CORPS. TO Baa CORPS.	0.92	0.92	0

UNDERWRITING

	FIRST QUARTER 1990	FIRST QUARTER 1989	% CHANGE 1990-1989
CORPORATE FINANCING (Gross New Issues - $ Mils)			
TOTAL	$78,918.2	$72,373.0	9.0%
Common Stock	$7,125.6	$3,899.5	82.7%
# of Common Stock Issues	114	68	67.6%
Preferred Stock	$1,314.8	$559.3	135.1%
# of Preferred Stock Issues	23	13	76.9%
Corporate Debt	$70,477.8	$67,914.2	3.8%
# of Corporate Debt Issues	1275	850	50.0%
MUNICIPAL FINANCING (Gross New Issues - $ Mils)			
Negotiated	$15,538.1	$18,134.9	-14.3%
# of Issues	661	967	-31.6%
Competitive	$7,825.1	$6,558.2	19.3%
# of Issues	774	772	0.3%

Source: IDD Information Services Inc.